



TOPICAL RESEARCH AND HIGHLIGHTS

THE EFFECT OF THE ECB MONETARY POLICY ON INTEREST RATES IN BULGARIA

(PUBLISHED AS PART OF 'ECONOMIC REVIEW',
VOL. 1/2016)



BULGARIAN NATIONAL BANK

The Effect of the ECB Monetary Policy on Interest Rates in Bulgaria

The currency board framework in Bulgaria, under which the exchange rate of the lev is fixed to the euro, ensures the accomplishment of the major central bank's goal of maintaining price stability in the economy. The fixed exchange rate of the lev *vis-à-vis* the euro, eliminating the lev exchange rate volatility, allows for euro area interest rate changes to have a strong impact on interest rates in Bulgaria. The currency board framework presupposes a direct transmission of the ECB's monetary policy to Bulgaria's economy. The banking system is an instrument for the transmission, with the ECB's monetary policy transmission being facilitated not only by the monetary regime but also by the substantial market share of EU foreign banks and bank branches¹ in Bulgaria.

The negative interest rates applied by the ECB on its deposit facility since mid-2014 and the non-standard monetary policy measures implemented due to the low euro area inflation, which is under the inflation target, prompted a decrease in all euro area interest rates. The present analysis aims to follow how changes in the ECB monetary policy, resulting from the negative interest rates applied to the deposit facility from 2014 until March 2016, spilled over interbank money market rates, deposit and lending rates in Bulgaria² under the currency board framework.

Between June 2014 and March 2016 against the background of a very low inflation rate, the ECB launched a series of standard and non-standard monetary policy measures intended to decrease interest rates, thus encouraging lending in the euro area. Higher domestic demand should have put an upward pressure on inflation, thus accelerating the achievement of the ECB inflation target:

- In June 2014 the ECB cut interest rates on its main refinancing operations by 10 basis points to 0.15 per cent, interest rates on the marginal lending facility by 35 basis points to 0.40 per cent and applied a negative interest rate on the deposit facility of -0.10 per cent, down 10 basis points.³ The ECB implemented additional measures to provide liquidity, including targeted longer-term refinancing operations (TLTROs) intended to boost lending to the euro area non-financial private sector by providing longer-term refinancing to banks under favourable conditions. Under this programme, banks might borrow funds from the ECB at an initial amount of up to 7 per cent of loans extended to the non-financial private sector (housing loans to households excluded) at two consecutive auctions in September and December 2014. Between March 2015 and June 2016 banks are allowed to borrow additional funds under this programme at three-monthly intervals. The programme became the major tool for the ECB to provide liquidity to euro area banks and gradually replaced the preceding programme of three-year longer-term refinancing operations (LTRO).
- In September 2014 the ECB cut the interest rates on its main refinancing operations, the marginal lending facility and the deposit facility by 10 basis points each to reach 0.05 per cent, 0.30 per cent and -0.20 per cent, respectively. In addition, the ECB announced an Asset-Backed Securities Purchase Programme (ABSPP) and a new (third in row) Covered Bond Purchase Programme (CBPP3), with securities issued by euro area banks. The implementation of the programmes started in the fourth quarter of 2014.
- In January 2015 the ECB announced a new package of non-standard monetary policy measures expanding the scope of asset purchases (Expanded Asset Purchase Programme, APP) to include

¹ By the end of 2015 the market share of EU foreign banks and branches in the assets of Bulgaria's banking system accounted for 75.1 per cent.

² For a more detailed analysis of the ECB measures and their effect on Bulgaria's banking system until 2014, see *The Effect of 2014 ECB Monetary Policy Measures on the Euro Area Financial Market and Bulgaria's Banking System*, Economic Review, 3/2014.

³ In addition to the deposit facility, the negative interest rate was also applied to: (i) banks' average reserve holdings in excess of the minimum required reserves; (ii) general government sector deposits held with the Eurosystem that exceed certain thresholds; (iii) Eurosystem reserve management services accounts if by the date of enforcement of the decision they have not been remunerated; (iv) participants' account balances in TARGET2; (v) non-Eurosystem NCB balances (overnight deposits) held in TARGET2; (vi) other accounts held by third parties with Eurosystem central banks, provided by the date of enforcement of the decision they have not been remunerated at the deposit facility rate.

bonds issued by euro area central governments, agencies and European institutions (a new programme: Public Sector Purchase Programme, PSPP). The total volume of monthly purchases of public and private financial instruments was projected to amount to EUR 60 billion, and purchases are intended to be carried out until at least September 2016.⁴ Purchases under the Public Sector Purchase Programme started in March 2015.

- In December 2015 the interest rate on the deposit facility was further cut by 10 basis points to -0.30 per cent. As regards the non-standard monetary policy measures, the ECB Governing Council decided: (i) to extend the duration of the extended asset purchase programme (APP) until at least March 2017; (ii) to reinvest the funds from securities purchased under the APP as they mature, for as long as necessary; (iii) to include in the Public Sector Purchase Programme (PSPP) purchases of euro-denominated marketable debt instruments issued by euro area regional and local governments; (iv) to continue to offer ample liquidity by means of the full allotment procedure in its regular refinancing operations, *i.e.* the main refinancing operations (MROs) and three-month longer-term refinancing operations (LTRO) at least until the end of 2017.
- In March 2016 the ECB decided to launch a new package of additional monetary policy measures. As part of it, the ECB cut interest rates on its main refinancing operations by 5 basis points to 0.00 per cent, on the marginal lending facility by 5 basis points to 0.25 per cent and on the deposit facility by 10 basis points to -0.40 per cent. The amount of monthly purchases under the extended Asset Purchase Programme was raised to EUR 80 billion starting from April 2016. A new Corporate Sector Purchase Programme (CSPP) was added for purchase of investment-grade bonds issued by non-bank corporations established in the euro area. The programme will start in June 2016. In addition, the ECB announced that in June 2016 it planned to launch a second programme of targeted longer-term refinancing operations (TLTROs-II), including a series of four targeted longer-term refinancing operations, each with a maturity of four years. Under this programme each bank's borrowing allowance shall equal up to 30 per cent of its loans to the non-financial private sector (housing loans to households excluded) as of 31 January 2016 less the amount of previously borrowed and still outstanding funds under the first two TLTROs conducted in 2014. The interest rate to be applied to amounts borrowed under TLTROs-II equals the main refinancing operations rate. The interest rate may be decreased to the deposit facility rate provided banks increase the net amount of loans to the non-financial private sector (housing loans to households excluded) by more than 2.5 per cent in the 1 February 2016 – 31 January 2018 period.

The transmission of the ECB monetary policy on the monetary conditions in Bulgaria leads first to a change in short-term money market interest rates. From June 2014 to the end of 2015, with the introduction of negative interest rates on the ECB deposit facility, the interbank market rates in the euro area tended to decline faster than those in the Bulgarian money market. This resulted in a gradual increase in the spreads between the interest rates on unsecured deposits with a maturity of up to six months in Bulgaria and in the euro area. The spreads between the interest rates on unsecured deposits with a maturity of over six months declined further. At the end of 2015 euro area money market interest rates reached a negative territory, including for transactions with a maturity of up to six months, while the quotations on the Bulgarian money market remained positive.

The slower decline in the interest rates on deposits with a maturity of up to six months and the increase in their spreads with the respective quotations on the euro area money market was largely due to the differences in the policies in Bulgaria and in the euro area with regard to the remuneration of banks' excess reserves. With the introduction of the negative deposit facility interest rate by the ECB, euro area banks started to pay interest to the ECB for the funds maintained under the deposit facility and for their excess reserves, while banks operating in Bulgaria had the opportunity to maintain excess reserves with the BNB without having to pay interest as the interest rate on excess reserves in Bulgaria was set at 0 per cent. The weak credit activity and the sustained

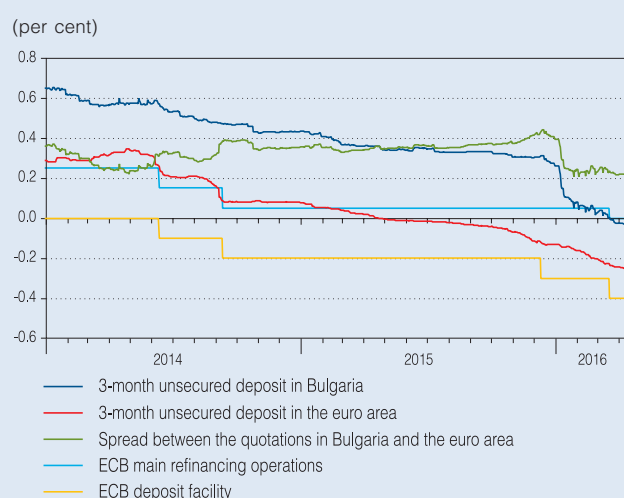
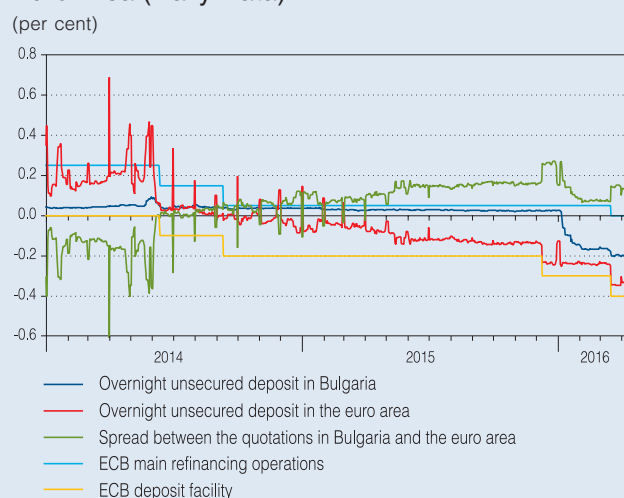
⁴ See Details on ECB Public Sector Purchase Programme, Economic Review, 1/2015.

high rate of growth in deposits from residents increased bank liquidity.⁵ Banks in Bulgaria found it more rational to keep a substantial portion of their holdings on their accounts with the BNB, rather than in deposit products offered in the euro area money market. The difference in the remuneration of the excess reserves in Bulgaria and the euro area also created arbitrage opportunities which helped avoid the negative interest rates in the euro area money market. The low interest rates on deposits in leva and in euro on the Bulgarian money market had an impact on the volumes of the interbank market trading in leva and euro in Bulgaria which fell rapidly since the second half of 2014, with a substantial increase in the transactions in US dollars being observed.

In December 2015 bank deposits with the BNB in excess of the minimum requirement reached 127.8 per cent on average, or BGN 7.6 billion compared to 56.5 per cent, or BGN 3 billion in the corresponding month of 2014. Furthermore, banks reduced their net foreign assets⁶ and increased the purchases of government securities issued by the Bulgarian government. The increase in banks' reserves as part of the liabilities of the BNB Issue Department resulted in an increase in BNB's international reserves.

In order to facilitate the transmission mechanism of the ECB policy on the Bulgarian economy, at the end of 2015 the BNB Governing Council adopted a new Ordinance No 21 on the Minimum Required Reserves Maintained by Banks which entered into force on 4 January 2016. The main new provisions in the latter are the introduction of a definition for banks' excess reserves with the BNB and the application of the ECB deposit facility interest rate on the excess reserves when this interest rate is negative. The BNB will continue to apply a zero interest rate on excess reserves where the ECB deposit facility rate is positive or nil. As regards the minimum required reserves, the BNB retained its policy of not incurring interest. Under the new Ordinance, the recognition of banks' funds in the TARGET2-BNB national

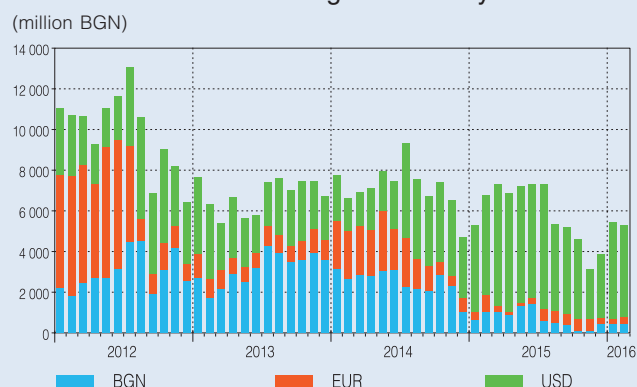
Money Market Interest Rates in Bulgaria and the Euro Area (Daily Data)



Note: Values reflect the average value of SOFIBOR and SOFIBID quotes for unsecured three-month deposits in leva.

Sources: BNB and ECB.

Volumes Traded in the Bulgarian Money Market

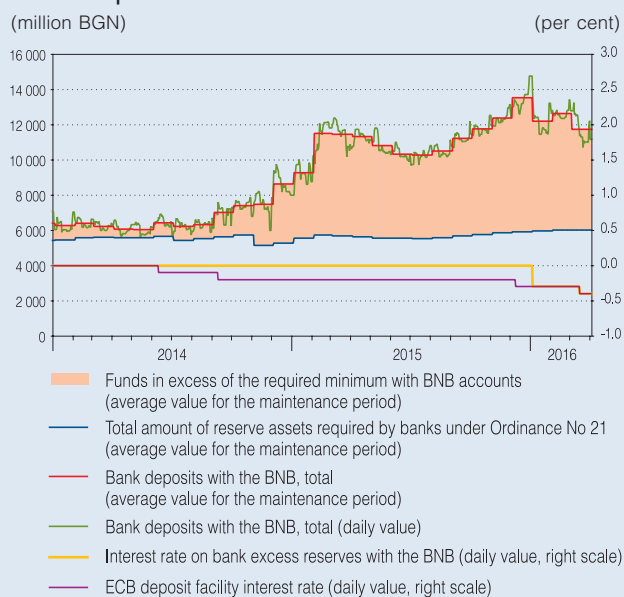


Source: BNB.

⁵ The payout of guaranteed deposits at KTB which were split between the other banks in the banking system had an additional effect thereto.

⁶ The supervisory measures taken by the BNB (see the box *BNB Precautionary Measures to Counteract External Risks to Bulgaria's Banking System*, Economic Review, 2/2015) also contributed to the decrease in banks' net foreign assets in 2015.

Bank Deposits with the BNB



Note: Data represent average values of relevant indicators in the reserve maintenance period under Ordinance No 21.

Source: BNB.

system component as reserve assets was removed.

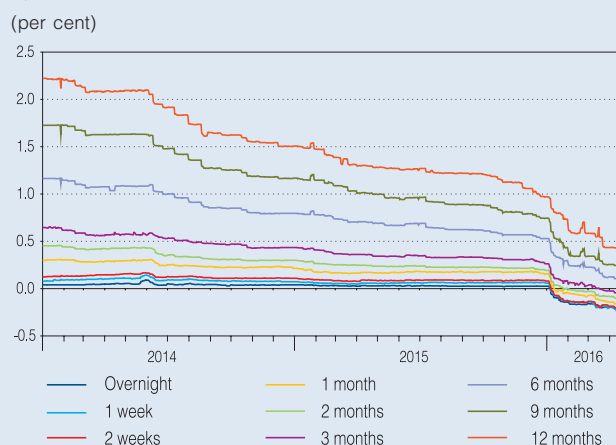
With the entry into force of the new Regulation No 21 on 4 January 2016, the quotations in levs in the interbank market in Bulgaria decreased sharply. In April quotations with a maturity of three months reached negative levels (from 29 basis points in December 2015 to -4 basis points in the first half of April 2016).

Over the same period the spreads between the quotations in the euro area money market also contracted, with that of unsecured deposits with a maturity of three months going down from 42 basis points to 21 basis points. A decline in the spreads was reported also in the quotations with a maturity of over three months. Upon the entry into force of the new Ordinance, bank reserves in excess of the required minimum contracted, with its average daily level in the maintenance period in March 2016 dropping by BGN 2 billion from the average daily level in the December 2015 maintenance period.

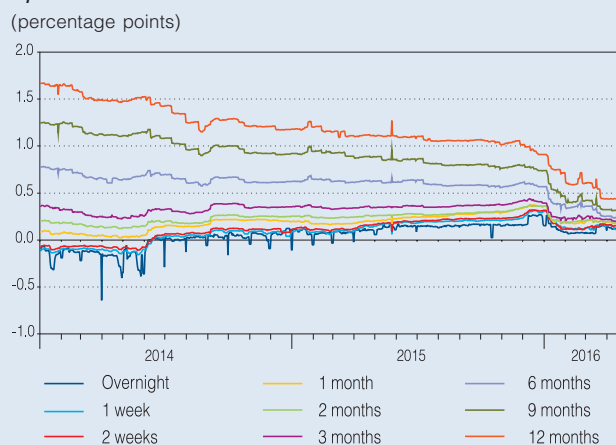
ECB policy coupled with the relatively high growth of attracted funds in the Bulgarian banking system, has a bearing also on the interest rates on new deposits which reached a historical low in late 2015 and early 2016.⁷ The lower cost of funds attracted by banks and the decline in the quotations of the interbank market in Bulgaria and in the euro area contributes, albeit with some delay, to the decrease in lending rates.⁸ This channel will have a limited impact on the further decrease in lending rates, and towards the year-end is likely to be exhausted, as in the event of a negative value, the banks using SOFIBOR and EUROBOR quotations as a reference rate usually assume the latter as nil. A downward trend was reported also in the spreads between lending rates in Bulgaria

Money Market Quotations in Bulgaria and Spreads vis-à-vis the Quotations in the Euro Area Money Market (Daily Data)

Quotations



Spreads



Note: Values reflect the average SOFIBOR/SOFIBID quotations for unsecured deposits in levs.

Sources: BNB and ECB.

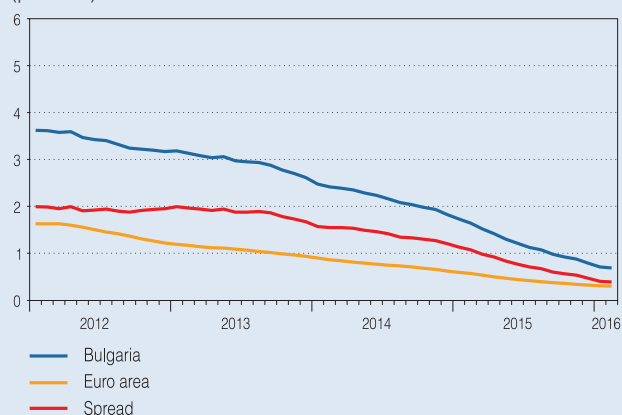
⁷ See Sub-section *Interest Rates* of Section 2.

⁸ Lending rates in Bulgaria are usually formed by using a benchmark (such as SOFIBOR, EURIBOR, etc.) and a mark-up for the credit risk of the customer. The provisions regarding consumer and housing loans are laid down in the amended Law on Consumer Credit, effective as of 23 July 2014.

Interest Rates on Deposits with an Agreed Maturity in Bulgaria and the Euro Area

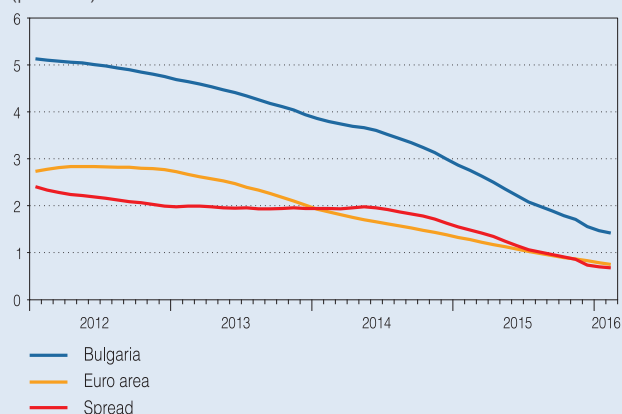
Non-financial corporations

(per cent)



Households

(per cent)



Note: Values for Bulgaria are the 12-month weighted averages on deposits *vis-à-vis* households and non-financial corporations in leva and in euro, and the values for the euro area are the 12-month weighted averages for deposits *vis-à-vis* households and non-financial corporations.

Sources: BNB and ECB.

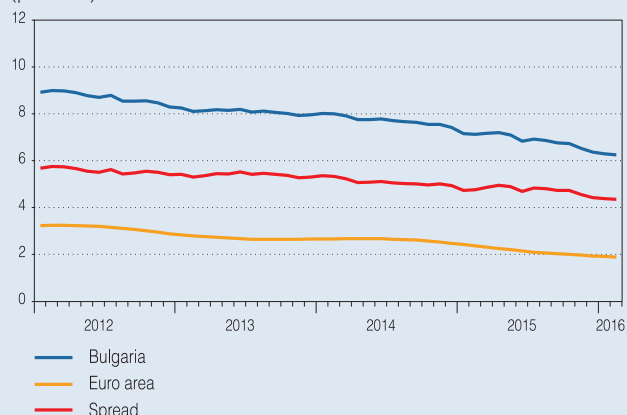
and the euro area on both loans to non-financial corporations and loans to households which reflects the gradual decline in the risk premium in the economy.

In the current phase of the interest rate cycle, a key contributor to the further decline in interest rates on loans in Bulgaria will be the economic growth and financial stability which – all other things being equal – would lead to a decline in borrowers' risk premium.

Interest Rates on Loans in Bulgaria and the Euro Area

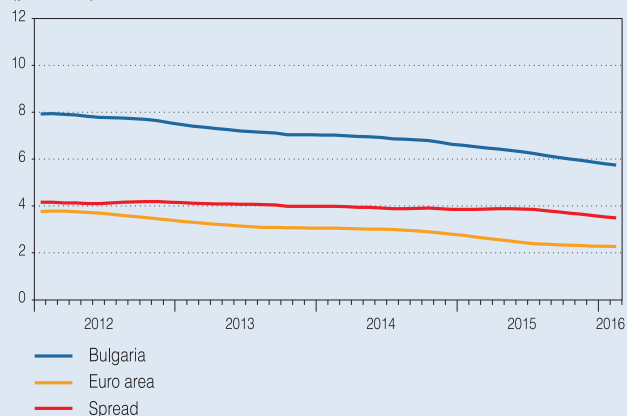
Non-financial corporations

(per cent)



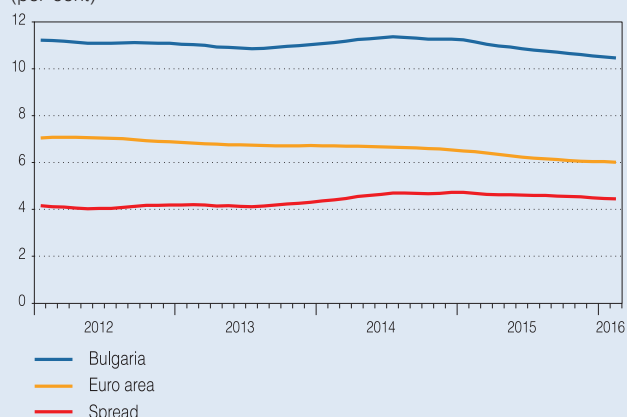
Housing loans

(per cent)



Consumer loans

(per cent)



Note: Values for Bulgaria are the 12-month weighted averages for loans in leva and euro and those for the euro area are the 12-month weighted averages for loans in euro.

Sources: BNB and ECB.

THE SCULPTURAL COMPOSITION BY KIRIL SHIVAROV DEPICTING HERMES AND DEMETER ON THE SOUTHERN FAÇADE OF THE BULGARIAN NATIONAL BANK BUILDING IS USED IN COVER DESIGN.